Review, Outlook and Opinion __________ October, 2008

By: Scott Walker, CFP

Bear markets come and go, and we are in the jaws of a beast as I write this. There have been few places to hide. Cash and equivalents, meaning money market accounts, CD's, and Treasury Bills have held up fine, and the low interest rates are tolerable when the principal stays intact. High grade municipal bonds for our tax-sensitive accounts have also performed relatively well. The tax-free interest these bonds pay will be more valuable if tax rates increase under the next administration in Washington.

Diversification has helped to limit the damage, and the good news is that we did some earlier selling to take profits and cut losses and build up an average of 25% cash in client accounts. The bad news this week is that we did not sell more, and many of our holdings are caught in the tsunami we're currently experiencing. We are reluctant to do any additional selling at the current levels, and have instead been tip toeing back in and buying some beaten down issues at bargain levels. No one rings a bell at the top or bottom of market cycles, but we do know that September and October have historically been the two worst performing months for the U.S. stock market. Alternatively, the November thru May period has produced the majority of stock gains, so we are keeping the faith and maintaining many core equity positions knowing that stocks have produced the best long-term results for invested capital.

The question now is how much of the bad news is already discounted in current prices and how close to a bottom are we? The risk/reward profile for stocks at this point is highly favorable. Valuations are very reasonable, investor sentiment is at record low levels, and we are seeing signs of capitulation with indiscriminate panic selling. These are all positive signs for a contrarian. Stock prices are leading indicators that typically turn up six to nine months prior to good economic numbers being released.

It's easy to sell everything and go to cash for temporary relief, but the problem is that after netting out inflation and taxes, our real rate of return is negative; and we risk missing the rebound. If $10,000 had been invested in the Standard & Poor's 500 stock index on January 1, 1980, it would be worth $121,029 on June 30, 2008. If the same investment missed the ten best performing days, it would be worth $70,745. Missing the ten best days out of 7,192 days would slash our total return by 42%. "Big money is made during bear markets like this; we just don't realize it at the time," a quote by Warren Buffet.

The roots of our current debacle can be traced to the 1930's when FDR's New Deal legislation created the Government Sponsored Entity, Fannie Mae. Freddie Mac was later created to compete with Fannie Mae, and good intentions by our lawmakers turned into a gravy train that funneled large campaign contributions to Washington politicians. Many financial institutions used leverage (borrowed money) to gorge on high yield mortgage backed securities during the housing bubble. With the collapse of housing prices, many of those mortgage securities have become illiquid and cannot be sold. The government bailout plan recently signed into law by President Bush will provide up to $700 billion to take these toxic securities off bank balance sheets. Some value will eventually be realized from those securities which will help offset the cost to taxpayers.

Equities – Looking to the future, we want to be positioned in areas that have strong rebound potential, like technology, health care, industrials, and energy. We are sticking with best of breed companies that have low or no debt, growing revenues and earnings, and management that is aligned with shareholder interests. We own Qualcomm, Hewlett Packard, Google, Cisco Systems, and Allergan. Beaten down blue chip dividend paying stalwarts like General Electric, 3M Company, and Chevron will survive and continue to increase dividends in the years to come. Berkshire Hathaway is like a giant mutual fund with low operating expenses. The diversified behemoth owns large blocks of stock in many companies including American Express and Wells Fargo, and has recently invested billions in 10% preferred stock from Goldman Sachs and GE.

Stock Funds – Fearing a slowdown in Europe with an overly restrictive central bank, last quarter we sold First Eagle Overseas, the remaining shares of Dodge & Cox International Stock as both funds had large stakes in the area. While growth has slowed in China, Southeast Asia is still the strongest economic engine in the world with trade and budget surpluses, so we have maintained our exposure to that region with the Matthews Asian Growth & Income Fund. Although the fund declined last quarter, Lipper results show it was the best performing fund in the Pacific ex-Japan category.

Exchange Traded Funds (ETF's) – With the sharp decline in energy and commodity prices, we were able to pick up a couple of ETF's in the commodity arena. The United States Natural Gas Fund (UNG) is designed to track the spot price of natural gas. Natural gas is the most environmentally friendly hydrocarbon for power generation, and our main supply lies beneath the ground in the U.S. We are sticking with the Energy Select Sector SPDR (XLE) for the best of the integrated majors and energy service companies.

For some accounts we also purchased shares in the SPDR Gold Trust (GLD) as a hedge against general stock market weakness and insurance against the debasement of paper currencies. The fund owns bars of gold bullion and closely tracks the spot price of gold.

Safe Money Investments – If funds will be needed in the next couple of years, return *of* principal is more important than return *on* principal. So where is a good place to park funds with peace of mind that the principal is safe? U.S. Treasury Bills, (Tbills) are widely regarded as the risk free benchmark of the world. The flight to safety has pushed yields down to all-time record lows, with the short-term 3-month bill yield now at approximately 0.60%. 6-month bills yield around 1%, a 2-year Treasury note earns 1.64%, and a 5-year Treasury note sports a 2.70% yield.

Money market mutual funds hold trillions of short-term savings and created a stir when the Primary Reserve Fund in New York "broke the buck" and saw its share price drop to 97 cents due to some impaired Lehman short-term paper. On September 19, 2008 the Treasury Department announced the establishment of a temporary, 12-month guaranty program for the U.S. money fund industry. All Schwab money market funds will participate in the program. All Schwab money funds also continue to meet their two primary objectives: 1) To always maintain a $1.00 net asset value, and 2) To continue to meet all daily redemption requests by clients. We are extremely confident in the financial strength of the Charles Schwab Corporation, and the safety of Schwab's money funds. Current yields are approximately 2%.

For those preferring FDIC insurance coverage, Congress recently increased the limit up to $250,000 per individual account versus the previous $100,000. We can purchase insured CD's through Schwab, with recent rates of 3.65% for a one-year, 4% for two years, and 5% for a five-year maturity.

Preferred Stocks – These hybrid securities rank behind bonds but ahead of common stock regarding the payment of dividends and upon liquidation. Most carry long-term 30-50 year maturity dates and pay quarterly dividends at higher rates than bonds. These holdings have been marked down in price as credit spreads have widened, but we are still receiving our dividends. Financial related issues have been hit the hardest, so we recently purchased the Bank One Capital VI 7.20%, (ONE+W) maturing 10/15/31. Bank One was acquired a couple of years ago by JP Morgan Chase. We regard JP Morgan Chase as one of the strongest banks in the U.S. Most preferreds carry a $25/share par or redemption value. ONE+W recently traded at $20/share, which represents a 9% current yield from the $1.80/share annual dividend which is paid quarterly.

Bond Funds – Prices on most all bond funds dipped in the third quarter. Indiscriminate selling by banks and hedge funds was the primary cause. We did exit our high yield junk bond funds to preserve capital with the expectation that defaults are likely to increase in the weak economic environment. Our remaining holdings are positioned mainly in short to intermediate maturity funds, like the Vanguard Short-Term Investment Grade, 4% yield; and the Metropolitan West Total Return Bond Fund, 5.5% yield. We have also taken a small position in a new fund, the Pimco Unconstrained Bond Fund, recently launched by the Newport Beach firm. The fund has a wide mandate and can shop anywhere in the world for cheap fare. They are still in the process of investing assets, resulting in a low current yield of 2.1%.

California municipal bonds have also dipped in price. Prudence dictated the sale of the American Century CA High Yield Fund. Believing that our current budgetary issues will be dealt with in Sacramento, we have purchased more shares in the Nuveen CA Select Tax Free Portfolio, (NXC). This non-leveraged closed-end fund owns many bonds, has an average credit quality of AA, below average expenses of 0.37%, and a net current tax-exempt distribution rate of 5.0% which is paid monthly. The Vanguard CA Intermediate-Term Tax-Exempt is another keeper.

These are tough times for all of us, but looking out over the next twelve months we believe stocks will likely outperform bonds and cash. We appreciate your continued trust and confidence. Please let us know if you have any questions, comments, or would like to schedule a review session to review your financial plan.

Scott Walker
October 8, 2008